No. 14,822

IN THE

United States Court of Appeals

For the Ninth Circuit

BLUMENFELD ENTERPRISES, INC., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

On Petition for Review of the Decision of The Tax Court of the United States.

REPLY BRIEF FOR PETITIONER.

SAMUEL TAYLOR,
WALTER G. SCHWARTZ,
1308 Balfour Building, San Francisco 4, California,
Counsel for Petitioner.

TAYLOR & SCHWARTZ,
1308 Balfour Building, San Francisco 4, California,
Of Counsel.

FILED

PAUL P. O'BRIEN, CLERK

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

Page

Comments on respondent's statement of facts.............. 1

Argument 2

I. Taxpayer sustained a loss not compensated for by insurance or otherwise on the demolition of its building 2

II. The tax Court's reasons for holding that taxpayer sustained no loss are not sound.................... 6

A. The fact that the term of the lease was longer than the expected useful life of the building is of no relevance in determining whether the taxpayer had sustained a loss........................ 6

B. The fact that permission to demolish the building was granted to the lessee in an option agreement is of no significance.......................... 9

C. The building was not demolished in connection with securing a lease........................ 12

Conclusion 21

Table of Authorities Cited

Cases

Pages

Albert L. Rowan (1954), 22 T.C. 865 .... 6, 7

Aristocrat Highway Displays v. Stricklen (1945), 68 Cal. App. 2d 788, 157 P. 2d 880 14

Brandow v. Holley (1932), 121 Cal. App. 460, 8 P. 2d 1044 15

Brown v. Oshiro (1945), 68 Cal. App. 2d 393, 156 P. 2d 976 14

Commissioner v. Moore (C.A. 9, 1953), 207 F. 2d 265 ...... 6, 7

Commissioner v. Pearson (C.A. 5, 1951), 188 F. 2d 72 ..... 6, 7

Continental Illinois Nat. B. & T. Co. v. United States (Ct. Cls. 1937), 18 F. Supp. 299 8

Eaton v. Commissioner of Internal Revenue (C.A. 9, 1936), 81 F. 2d 332, on second appeal (1938), 95 F. 2d 268 .... 3, 4

Glens Falls Indemnity Company v. Perscallo (1950), 96 Cal. App. 2d 799, 216 P. 2d 567 14

Grace v. Croninger (1936), 12 Cal. 2d 603, 55 P. 2d 941 ... 15

Lamson Bldg. Co. v. Commissioner (C.A. 6, 1944), 141 F. 2d 408 .... 7, 8

Lloyd v. Murphy (1944), 25 Cal. 2d 48, 153 P. 2d 47 14

McCulloch v. Liguori (1948), 88 Cal. App. 2d 366, 199 P. 2d 25 14

Smith Real Estate Co. v. Page (1933), 67 F. 2d 462 ...... 2, 3, 19

Spinks Realty Co. v. Burnet (C.A. D.C. 1932), 62 F. 2d 860, cert den. 290 U.S. 636 .... 7, 8

Young v. Commissioner (C.A. 9, 1932) 59 F. 2d 691, cert. den. 287 U.S. 632 .... 7, 8

Codes

Internal Revenue Code of 1939, Section 117(j) 10, 18

Texts

12 Cal. Jur. 2d 226 15

No. 14,822

IN THE

United States Court of Appeals
For the Ninth Circuit

BLUMENFELD ENTERPRISES, INC., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	}

On Petition for Review of the Decision of The Tax Court of the United States.

REPLY BRIEF FOR PETITIONER.

COMMENTS ON RESPONDENT'S STATEMENT OF FACTS.

There is little, if any, dispute as to the facts of the case (R 86-93; PB 3-9;* RB 3-10). Petitioner does object, however, to the distorted emphasis which both the respondent and the Tax Court place upon the option agreement of April 24, 1950 by referring to it as "a letter agreement looking towards the purchase of the entire Tivoli property by the lessee" (RB 6; R 89). This statement gives the impression that the demolition of the building was an integral part of the

*The briefs for Petitioner and Respondent are herein referred to as "PB" and "RB", respectively.

purchase by the lessee. However, a reading of the letter agreement clearly shows this was not the case (Exh. 4-D; R 52-54). The agreement, it is true, granted the lessee an option to purchase the property, but it gave him the absolute right, regardless of whether or not he exercised the option, to demolish the theatre building. The undisputed evidence shows, and the Tax Court found, that when the agreement was entered into, the lessee had not determined whether he would exercise the option (R 91).

ARGUMENT.

I. TAXPAYER SUSTAINED A LOSS NOT COMPENSATED FOR BY INSURANCE OR OTHERWISE ON THE DEMOLITION OF ITS BUILDING.

Respondent argues that "where the owner demolished his building in order to lease land to a tenant who is to erect new buildings, there is no uncompensated loss" (RB 12-13). He also points out that this rule has been applied in a few cases even when the lessee has not been obligated to construct a new building (RB 13-14). However, as we have already pointed out (PB 36-37), the Court of Appeals for the First Circuit in *Smith Real Estate Co. v. Page* (1933), 67 F. 2d 462 stated that this rule did not apply where the existing buildings had become valueless at the time of the lease. In such a case, the Court said, the transfer of the buildings to the lessee for the purpose of demolition would make the loss fully and immediately deductible. It is undisputed that in the instant case

the building was valueless at the time of its demolition (R 123, 137-148). Respondent makes no attempt to distinguish the *Smith* case nor does he argue that the building here involved had any value when it was demolished (RB 19).

Furthermore, permission to demolish the building was *not* given by the petitioner in the instant case in order to secure a lease; a valid lease was in existence prior to demolition and before either party had even considered the possibility of demolishing the building (R 88-89).

Respondent here cites a number of cases (RB 11-14), none of which is in point. All of these cases involve either (1) the situation described in Section 29.23(e)-2 of Regulations 111, to-wit, the case where real estate is purchased with the intention of demolishing the building thereon in order to erect a new building, or (2) a situation where a building is demolished in order to secure a lease, frequently with the lessee's obligation to erect a new building. In both situations, the unrecovered basis of the old building enters into the cost basis of the newly purchased property or of the newly acquired lease and is not immediately deductible. Such, however, is not the situation here.

At least one of the cases cited by the respondent points out this distinction. In *Eaton v. Commissioner of Internal Revenue* (C.A. 9, 1936) 81 F. 2d 332, on second appeal (1938) 95 F. 2d 268, a taxpayer purchased an orchard and shortly thereafter removed the trees therefrom and grew lettuce on the land. He

claimed a deduction for the cost of removing the trees. The Board of Tax Appeals denied the claimed deduction without finding whether or not the taxpayer intended to remove the trees at the time that he acquired the land. This Court remanded the case for such a finding. It stated that if the taxpayer had purchased the land in order to continue the business of growing apples and pears thereon, but thereafter ascertained that he could not do so with profit and for that reason destroyed the trees, he would be entitled to a deductible loss. If, on the other hand, he intended when he purchased the land to uproot the trees and enter upon the business of growing lettuce, the loss was not deductible.

The *Eaton* case therefore supports petitioner's position rather than respondent's. Here, when taxpayer acquired the property and when taxpayer and lessee entered into the lease, there was no intention to demolish the building. Therefore the permission to demolish can not be said to have been given in exchange for the leasehold.

The respondent then argues that no loss is allowable here since "the building was demolished so that the land could be put to a more productive use" (RB 14). Under this reasoning, if a taxpayer sold or otherwise disposed of an unproductive security or other asset and purchased a more profitable one, the loss on the disposition of the first would be denied. Furthermore, the respondent does not explain why the lease which had the same term and called for the same rental payments before and after permission to de-

molish the building was given was more productive after demolition than before.

The respondent then states (RB 14):

> "If we look at the context, however, we see that by the entire transaction taxpayer had substituted for one form of property another of greater value" (RB 14).

This statement is incorrect. Only by combining two independent transactions can it be said in any sense of the term that "taxpayer had substituted for one form of property another of greater value." The simple facts of the matter are that the building was *not* demolished in order to obtain a lease and that the leasehold was no substitute for the building. The lease was executed on October 6, 1949 (R 87-88). At that time neither the petitioner nor the lessee had any intention of demolishing the theatre building (R 88-89). The lessee intended to convert the property into a public garage (R 87-88). No thought was given to demolishing the building until several months after the lease was entered into (R 136). Permission was not given to the lessee to demolish the building until April 24, 1950 over six months after execution of the lease. Hence, the taxpayer did not grant permission to demolish the building in order to secure the lease, and it can not be said that taxpayer had merely substituted for one form of property (the theatre building) another of greater value (the lease).

II. THE TAX COURT'S REASONS FOR HOLDING THAT TAXPAYER SUSTAINED NO LOSS ARE NOT SOUND.

A. The Fact That the Term of the Lease Was Longer Than the Expected Useful Life of the Building Is of No Relevance in Determining Whether the Taxpayer Had Sustained a Loss.

The respondent argues that since the building had an expected useful life of less than sixteen years when the lease was entered into, and since it was subject to a twenty-five year lease, there could be no loss to the taxpayer upon the demolition of the building, citing *Commissioner v. Moore* (C.A. 9, 1953), 207 F. 2d 265 and *Commissioner v. Pearson* (C.A. 5, 1951), 188 F. 2d 72. Neither of these cases is authority for denying a loss under these circumstances. In both cases a taxpayer inherited an interest in land on which a building had been constructed by the lessee without cost to the lessor. The taxpayer claimed depreciation on the building. These cases were thus like the Tax Court case of *Albert L. Rowan* (1954), 22 T.C. 865, cited by the Tax Court in its decision in the instant case (R 97) and distinguished in petitioner's brief (PB 19-20). The Court of Appeals for the Fifth Circuit in the *Pearson* case did not even reach the merits of the case but merely held that the heir had failed to establish a basis for depreciation by failing to show how much of the estate tax valuation was attributable to the building, as distinguished from the land, and by failing to show whether the stipulated value attributable to the building entered into the value of the property for estate tax purposes.

This Court denied the claimed depreciation deduction in the *Moore* case. Just as in the *Rowan* case, the

decedent (the original lessor) in the *Moore* case had no investment in, and hence no basis for the building. Since the lessee had constructed the building, he was being allowed depreciation thereon and permitting the heir a depreciation deduction would be allowing the same deduction to two different taxpayers.

No demolition loss was involved in the *Moore, Pearson* or *Rowan* cases; no question of depreciation is involved here—the taxpayer in the instant case was admittedly entitled to depreciation while the building was in existence. Here, the taxpayer had an investment in and a cost basis (acquired by purchase) for the Tivoli theatre building. There is no possibility of a double deduction here; there is no question as to whether or not the lessee is entitled to the loss.

Petitioner pointed out (PB 18) that if the rule of law is that, where the term of a lease extends beyond the useful life of a building, the taxpayer incurs no loss upon the demolition of the building, it necessarily follows that such a lessor would also lose his right to depreciation over the useful life of the building. Such a taxpayer would then be permitted only to amortize the remaining cost of the building over the term of the lease. The petitioner added that this very argument had been made by the Commissioner and rejected by the Court of Appeals in *Lamson Bldg. Co. v. Commissioner* (C.A. 6, 1944), 141 F. 2d 408 (PB 18-19). The respondent states that the cases of *Young v. Commissioner* (C.A. 9, 1932) 59 F. 2d 691, *cert. den.* 287 U.S. 632; *Spinks Realty Co. v. Burnet* (C.A. D.C. 1932), 62 F. 2d 860, *cert den.* 290 U.S. 636,

and *Continental Illinois Nat. B. & T. Co. v. United States* (Ct. Cls. 1937), 18 F. Supp. 299 are contrary to the *Lamson* case (RB 15 footnote). This is incorrect. In the *Young, Spinks* and *Continental* cases, the buildings were demolished in order to secure a lease under which the lessee promised to construct a new building. The Courts therefore held that the remaining cost of the old building was amortizable over the term of the lease. There was no implication in any of these cases that depreciation would have been required to be taken over the term of the lease rather than over the remaining lifetime if the building had not been demolished.

Respondent then argues that "the remaining life of the building was compensated for by the lease payments, which were not to be diminished by removal of the building. Taxpayer was no worse off after the removal than before." (RB 15). There is no more reason for denying the claimed demolition loss by reason of the lease modification of April 24, 1950 than there is for denying depreciation to the taxpayer by reason of the original lease of October 6, 1949. Immediately after the original lease was entered into, taxpayer still had his building with a remaining cost basis to it of over $130,000 and also had a lease calling for payments totaling $420,000. When the building was demolished under the modification agreement of April 24, 1950, the taxpayer no longer had the building but still had a lease for the same term providing for the same rentals. Taxpayer was clearly worse off after the removal than before; prior to it he had the build-

ing with a remaining cost of over $130,000; after it, he had no building. Nor was he compensated for this loss by an advantageous lease since he had the lease prior to as well as after the demolition of the building.

B. The Fact That Permission to Demolish the Building Was Granted to the Lessee in an Option Agreement Is of No Significance.

Respondent argues next that the agreement of April 24, 1950 was in effect both a lease and an option to sell (RB 16). (Actually, of course, it was a lease modification rather than a lease.) Respondent continues that if the agreement is regarded as an option to sell, then the permission to demolish the building and its immediate demolition were part of a sale with gain or loss to be determined in the year in which the sale took place.

However, the undisputed evidence is and the Tax Court found that when the letter agreement of April 24, 1950 was entered into, the lessee had not determined whether he would exercise the option to purchase which was given therein (R 91). Furthermore, the option, originally scheduled to expire April 24, 1950 was later extended to expire on October 1, 1951 and was not exercised until September 27, 1951 (R 91-92). The respondent cites no authority for the unusual proposition that the demolition of the building in the taxpayer's fiscal year ended July 31, 1950 was somehow part of a sale of the underlying land which was not made (and which it was not known would be made) until the petitioner's fiscal year ended July 31, 1952. If the taxpayer suffered a loss on

the demolition of its building in its 1950 fiscal year, this is no authority and no reason for postponing recognition of the loss to a subsequent taxable year merely because it might well sell (and actually did sell) the underlying land in a subsequent year.

If the demolition of the building is to be considered somehow connected with the sale of the property as a whole, then the Tivoli theatre building was not sold to the lessee on September 27, 1951 when the lessee exercised his option to purchase the remaining portions of the Tivoli property since the theatre building was no longer in existence then. Rather, the theatre building was sold, if it was sold at all, in the taxpayer's fiscal year ended July 31, 1950 when the taxpayer gave the lessee permission to demolish the building and when the building was actually in fact demolished. At the end of the petitioner's fiscal year ended July 31, 1950, it was uncertain whether or not the underlying land would be sold; but it was absolutely certain that taxpayer would never receive back the Tivoli theatre building. If then, the transaction is to be considered a sale, there was a sale of the Tivoli Theatre building in the petitioner's fiscal year ended July 31, 1950 and an ordinary loss would be allowable to the petitioner under Section 117(j) of the Internal Revenue Code of 1939.

Respondent then argues that the demolition arose in connection with negotiations between the taxpayer and the lessee "looking to either a continuance of the lease or a sale" (RB 16-17). He concedes that the decision to demolish the building may well have been "an inde-

pendent event, in the sense that it was not contemplated in October, 1949, when the lease was first entered into.'' He argues, however, that "It was not independent of the relationship between taxpayer and lessee as marked by the letter agreement of April 24, 1950, the formal agreement of February 23, 1951 and the final sale of September 27, 1951.''

It is misleading to state that the demolition arose in connection with negotiations between taxpayer and the lessee looking to either a continuance of the lease or a sale. When these negotiations which resulted in the agreement of April 24, 1950 commenced, the lease was not scheduled to expire until April 30, 1975. No extension of the term of the lease was made by the modification agreement of April 24, 1950, nor was any sale made thereby. The lessee was given an option to purchase the entire property. This option to purchase was not something received by the taxpayer in exchange for its permission to demolish the building; rather, it was a concession by the taxpayer to the lessee. Respondent's statement ignores the Tax Court's finding (R 91) that it was not known when the agreement of April 24, 1950 was entered into whether or not the option would be exercised. The demolition was thus independent of the sale of the remaining property which was finally made on September 27, 1951. What difference is there whether or not the demolition was "independent of the relationship between taxpayer and lessee as marked by the letter agreement of April 24, 1950, the formal agreement of February 23, 1951 and the final sale of Sep-

tember 27, 1951" (RB 17)? There is no doctrine in the law that requires the disallowance of a claimed demolition loss when permission to demolish is given at the same time that a lease is modified or at the same time that an option to purchase the building is entered into. The cases merely hold that where permission to demolish the building is given in order to secure an advantageous lease, the demolition loss is not allowable unless the building was of no value at the time of demolition. Here, as will be further demonstrated, permission to demolish was not given in order to secure an advantageous lease.

C. The Building Was Not Demolished in Connection With Securing a Lease.

As respondent states, taxpayer argued (PB 24-37) that at the time of the demolition the lease of October 6, 1949 was a valid and valuable lease, that the demolition was not necessary to secure for taxpayer the benefits of that lease, and that therefore the demolition, not having been anticipated at the time the lease was entered into, under the cases cited by the taxpayer (PB 29-32) constituted an allowable deduction. Respondent does not attempt to distinguish or question those cases or to deny taxpayer's premise that if the lease was valid when the modification agreement was entered into, the building was not demolished in order to secure a lease.

The distinguishing and inescapable fact is that the building in the present case was not demolished in order to secure the October 6, 1949 lease, and there-

fore the demolition loss is allowable. The respondent seeks to avoid this crucial and controlling fact by indulging in a devious and speculative argument. He argues that when the City and County of San Francisco refused to approve the lessee's plans, "both legally and practically, the lease was of doubtful value to the lessor," and that "It was doubtful whether it [the lease] was enforcible [sic] when it had become impossible to use the premises for the purposes contemplated" (R 17-18). Hence, argues respondent, the supplemental agreement of April 24, 1950 is the controlling document and the building was demolished in order to secure this new agreement.

There is not one shred of evidence in the record to indicate or even suggest that either of the parties thought that the original lease was unenforceable or that lessee's performance was excused for any reason. Both lessor and lessee at all times considered the lease as a valid and binding obligation. No issue was made in the government's notice of deficiency, nor in the pleadings of either party, nor at the trial, that the lease of October 6, 1949 was ineffective, invalid or of little value.

Respondent's speculations have no firmer foundation in the law than they have in the facts. Significantly, he cites no authority in support of his argument that the lease was legally unenforceable. On the contrary, it clearly appears that the lease was a binding and a legally enforceable obligation. The conditions imposed by the San Francisco authorities

did not forbid the conversion of the building into a garage but merely increased the anticipated cost of conversion from between $45,000 and $50,000 to in excess of $125,000 (R 88-89).

California Courts, as well as Courts in other jurisdictions, have repeatedly held that the mere fact that performance of a contract is made unprofitable, or more difficult, or more expensive than the parties anticipated when the contract was made will not excuse the duty of the promisor to perform his part of the agreement. See, for example, *Glens Falls Indemnity Company v. Perscallo* (1950), 96 Cal. App. 2d 799, 216 P. 2d 567 (contractor not excused from performing contract for construction of highway where government regulations made work more difficult and expensive); *Lloyd v. Murphy* (1944), 25 Cal. 2d 48, 153 P. 2d 47 (lease of premises for sale and repair of new automobiles not terminated by government act restricting sale of cars); *Brown v. Oshiro* (1945), 68 Cal. App. 2d 393, 156 P. 2d 976 (lease not terminable where tenant prevented from operating hotel because of evacuation of Japanese during war); *McCulloch v. Liguori* (1948), 88 Cal. App. 2d 366, 199 P. 2d 25 (contract to lease building not excused on theory of impossibility where government regulations made construction more difficult and costly); *Aristocrat Highway Displays v. Stricklen* (1945), 68 Cal. App. 2d 788, 157 P. 2d 880 (rent not recoverable on contract for outdoor illuminated advertising where cost of performance made more expensive and difficult by reason of wartime ordinance regulating illumination at

night); *Grace v. Croninger* (1936), 12 Cal. 2d 603, 55 P. 2d 941 (lease for purpose of conducting a saloon and cigar store not terminated as a result of law making liquor business illegal); *Brandow v. Holley* (1932), 121 Cal. App. 460, 8 P. 2d 1044 (lessee of garage not excused from paying rent on theory building not reasonably fit and suitable for business as result of ordinance prohibiting storage of gasoline in premises).

The California rule on impossibility or commercial frustration is succinctly stated in 12 *Cal. Jur.* 2d 226 as follows:

> "Parties should be careful about making contracts, for once made the courts will not relieve them for light or trivial reasons. Public policy is subserved by leaving the parties and their rights to be measured by the terms of their engagements. They may have made an unfortunate arrangement, but when they have entered into it voluntarily they are bound by it in the absense of equitable grounds for avoidance. They must be presumed to have contracted with reference to existing conditions known to them. A person contracting with eyes open and aware of the facts is presumed to undertake performance at the risk of interference from agencies not expressly provided against. Moreover, contracting parties cannot escape performance of their undertakings because of unforeseen hardship. Similarly, mere difficulty or unusual or unexpected expense will not excuse a party from failing to comply with the terms of his contract. Nor is it a defense that the law has rendered performance difficult or expensive."

Unlike the present case, in all of the cases cited above the event causing the alleged impossibility arose after execution of the agreement. If a promisor is not excused from performance of his promises where fortuitous supervening events produce unanticipated costs or hardships, surely with greater force the same result follows where, as here, all of the circumstances are in existence at the time of the making of the contract. In the present case, the City and County building requirements were in existence when the lease was executed and remained in effect without change. The possibility that additional cost would be incurred in remodeling the building was foreseeable and could have been anticipated and guarded against by the lessee. This was a risk which under California law the lessee is presumed to have assumed. Furthermore, there is not a scintilla of evidence that the lessee questioned the validity of the lease.

Since the lease was at all times a legally enforceable agreement and so recognized by the parties and not a worthless and unenforceable agreement as respondent would have the Court believe, the facts admit only of the conclusion that the taxpayer permitted demolition of the building solely because it was worthless and not in order to secure a lease or even a supplemental agreement.

Respondent cannot satisfactorily explain why the agreement of April 24, 1950 "was both a different and a more valuable lease" than the original lease of October 6, 1949 (RB 18). The April 24, 1950 agree-

ment (Exh. 4-D, R 52-54) modified the lease of October 6, 1949 in the following respects:

1. It gave the lessee in consideration for $25,000, an option to purchase the entire Tivoli property at an agreed price and upon specified terms.

2. In the event that the option was not exercised within one year, the $25,000 consideration for the option was to remain with the lessor as an additional lease deposit under the lease of October 6, 1949 to be deducted from the rentals at the end of the lease term.

3. The lessee was given permission to demolish the Tivoli theatre building "for the purposes conforming to said lease" and to "furnish to the lessor modified plans showing the proposed basement and ground floor development."

The agreement of April 24, 1950 specifically provides:

> "6. The Seller, as the lessor, expressly retains all of their [sic] rights under the aforementioned lease dated October 6, 1949, and makes no waiver of any of the conditions of said lease, including but not limited to the $10,000.00 guarantee by Mr. Herman Hertz."

Certainly the granting to the lessee of an option to purchase the lease did not make the lease more valuable. It was a detriment and not a benefit to the taxpayer and cannot be said to be an asset received by the taxpayer in exchange for its permission to demolish the property. No change was made with respect to the purpose of the lease; the property was still

to be used for garage and parking operations. The term of the lease was not changed, nor was the agreed rental raised. As taxpayer pointed out (PB 26-27), the $25,000 did not become the property of the taxpayer outright in exchange for permission to demolish; rather it was to be applied against the purchase price if the option was exercised and was to constitute merely an additional lease deposit if it was not exercised. Furthermore, even if it can be said that this amount was received by the taxpayer in exchange for its permission to demolish the building, the transaction would constitute a sale of the building for that amount resulting in a loss which would constitute an ordinary loss under Section 117(j) of the Internal Revenue Code of 1939 (PB 27 note).

As stated earlier, no finding was made by the Court (nor was the issue ever raised by respondent) as to the value of the lease of October 6, 1949 before and after its amendment on April 24, 1950. If this Court deems this point to be of any importance, it is respectfully submitted that the case should be remanded to the Tax Court for further evidence on the valuation question. Such a question should not be decided upon the basis of speculation and hypothesis, as the government contends, but on the basis of evidence in the record.

The petitioner argued also (PB 36-37) that even if the agreement of April 24, 1950 were considered to be a valuable new lease secured by granting permission to demolish the building, the loss on the old building

is nevertheless deductible if it was in fact worthless at the time, citing *Smith Real Estate Co. v. Page* (C.A. 1, 1933), 67 F. 2d 462. The respondent does not attempt to distinguish the *Smith* case nor does he quote any cases in opposition to the proposition of that case. He therefore admits that the *Smith* case is in point here. He expresses doubt as to the soundness of the distinction brought out in the *Smith Real Estate Co.* case. However, the soundness of the distinction, it is submitted, is clearly apparent in the following quotation from the Court's opinion in that case:

> "The correct conclusion depends, as it seems to us, on the facts in the particular case. If the existing buildings had become valueless at the time of the lease, it is probably false to the fact to say that the lessee paid, in any form or guise, compensation for them. Under such circumstances, the loss on the buildings had already occurred when the lease was made. It was not yet deductible for income tax purposes because no steps had been taken to fix it. But the transfer of the buildings to the lessee would have that effect, and would make the loss immediately deductible. On the other hand, if the buildings had value at the time of the lease, such value was surrendered to the lessee and was presumably compensated by the provisions in the lease. * * *"

Respondent's final argument is that taxpayer started with an asset (the Tivoli Theatre building) with a basis of $132,284.42 and ended with another asset of value, a lease calling for total payments of

$420,000, and requiring the lessee to assume certain additional expenses, in razing the building, to make the parcel more useful and productive (RB 19-20). The respondent, first, misstates the terms of the agreement of April 24, 1950. It did not require the lessee to assume certain additional expenses in razing the building; it merely gave the lessee permission to demolish the building. In other words, this was a concession to the lessee permitting him to demolish the building and not a concession to the lessor. Actually, taxpayer in the instant case started with an asset (the Tivoli Theatre building) with a basis of $132,284.42 and a lease calling for total payments of $420,000 and after the permission to demolish the building was given and the building was actually demolished, it had only the second of the assets, the lease calling for total payments of $420,000. Permission to demolish the building was not given in order to secure the lease; the lease had already been secured. The agreement of April 24, 1950 did not make the parcel more useful and productive to the lessor; its rents were the same under the original lease as under the amendment.

CONCLUSION.

The decision of the Tax Court is erroneous and should be reversed.

Dated, San Francisco, California,
March 5, 1956.

Respectfully submitted,

SAMUEL TAYLOR,
WALTER G. SCHWARTZ,
Counsel for Petitioner.

TAYLOR & SCHWARTZ,
Of Counsel.